

Internal Revenue Service

memorandum

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Brl:JDMacEachen

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to: District Counsel, Jacksonville CC:JAX
Attn: Thomas R. Ascher, Special Trial Attorney

from: Assistant Chief Counsel (Tax Litigation) CC:TL

subject: [REDACTED]

This is in response to your request for technical advice of September 12, 1988.

ISSUE

When is a long-term contract "finally completed and accepted" within the meaning of Treas. Reg. § 1.451-3. 0451-1600

CONCLUSION

The subject contract for the design, manufacture and erection of a [REDACTED] is considered to be finally completed and accepted on the first day of the taxpayer's first taxable year ending after [REDACTED]. Taxpayer is on a [REDACTED] fiscal year. Accordingly, the contract is considered completed on [REDACTED], and is taxable in taxpayer's fiscal year ended [REDACTED].

FACTS

On [REDACTED], the [REDACTED] contracted with [REDACTED] to design, manufacture and erect a [REDACTED] for the [REDACTED] at [REDACTED]. The contract, [REDACTED], called for [REDACTED], designated [REDACTED] and [REDACTED], with an option for a [REDACTED], at a total price of at least \$ [REDACTED]. The project was to commence in [REDACTED], and the [REDACTED] were to be placed in commercial operation by [REDACTED] and [REDACTED], respectively. The contract required that [REDACTED] be billed monthly as the project progressed. [REDACTED] percent of each billing was to be remitted by [REDACTED]. A [REDACTED] percent retainage was to be kept by [REDACTED] pending the satisfactory completion of the performance tests specified in the contract.

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The [redacted] were in fact placed into commercial operation not later than [redacted], and [redacted], respectively, and have been operated by [redacted] at their designed capacity since that time.

Contract [redacted] required that the [redacted], once in operation, conform to precise technical specifications in terms of capacity, performance, efficiency, etc. Testing was to begin as soon as practical after all portions of a given unit were operating in a normal manner. In case of the failure of the equipment to meet any of the performance standards [redacted] retained the right to operate the equipment until the standards had been complied with. Only upon compliance with the performance standards would the contract be certified by [redacted] as complete.

Notwithstanding the fact that [redacted] were placed into commercial service by [redacted], [redacted] experienced problems in demonstrating that several peripheral systems, the [redacted], the [redacted] and the [redacted], fully complied with the contract. These problems generally did not interfere with the operation or safety of the equipment, but only with its efficiency; i.e., until the problems were resolved, the equipment burned more fuel than it otherwise would have. [redacted] continued the commercial operation of the equipment during the time [redacted] was working on these problems, and permitted the necessary modifications only during regularly scheduled plant shut-downs. The [redacted] problems related to leakage of air, and were corrected by [redacted]. The [redacted] problems related to excessive vibration and were corrected by [redacted]. The [redacted] problems related to excessive [redacted], and were corrected by [redacted]. The cost of these repairs, over a four year period, was approximately \$ [redacted], or [redacted] percent of the contract price.

Taxpayer closed the portion of Contract [redacted] relating to [redacted] and [redacted] during its fiscal year ended [redacted]. Taxpayer now asserts that as these [redacted] did not comply with all the requirements of the contract until [redacted], the contract should not be considered closed until taxpayer's fiscal year ended [redacted].

ANALYSIS

As noted above, the subject contract was executed in [redacted]. The [redacted] were placed into commercial operation in [redacted] and [redacted] respectively, but did not meet all of the performance requirements of the contract until [redacted]. During this period the taxability of long-term contracts was controlled by two sets of regulations, each of which will be discussed in turn.

Before 1976, under the 1939 and 1954 Codes and prior Revenue Acts, gross income from long-term contracts accounted for under the completed contract method of accounting was reportable "in the taxable year in which the contract is finally completed and accepted...." Treas. Reg. § 1.451-3(b)(2), adopted Dec. 24, 1957, under the 1954 Code; Treas. Reg. 118, Sec. 39.42-4(2), under the 1939 Code; see Treas. Reg. 111, Sec. 29.42-4(b) and Treas. Reg. 62, Art. 45, Sec. 36, under prior Revenue Acts.

Under the pre-1976 regulations, the Tax Court held that the words "finally completed and accepted" mean "when the contractor has substantially performed his contract even though some minor particulars such as remedying defects may yet remain to be done". Hooper Construction Co. v. Renegotiation Board, 35 T.C. 837, 847 (1961); Ehret-Day Co. v. Commissioner, 2 T.C. 25, 34 (1943), acq., 1943 C.B. 7. On the other hand, under the same regulations, several appellate courts and a district court had adopted a literal interpretation of the phrase "finally completed and accepted". Thompson-King-Tate, Inc. v. United States, 296 F.2d 290 (6th Cir. 1961); E.E. Black, Ltd. v. Alsup, 211 F.2d 879 (9th Cir. 1954); Rice, Barton & Fales, Inc. v. Commissioner, 41 F.2d 339 (1st Cir. 1930); King, Jr. v. United States, 220 F. Supp. 350 (ED Tex. 1963).

The 1976 regulations resolved this split by adopting a literal interpretation of the term "completed". A long-term contract was not considered completed until final completion and acceptance had occurred. Nevertheless, a taxpayer could not delay the completion of a contract for the principal purpose of deferring Federal income tax. See Treas. Reg. § 1.451-3(b)(2), T.D. 7397 (January 12, 1976)

Earlier drafts of the 1976 regulations had adopted the "substantial completion" test of the Tax Court. However, the regulations, as finally adopted,

return to the "final completion and acceptance" approach of prior law. However, in order to prevent any inference that the Service is now repudiating the favorable tax cases, the revised notice also contains a sentence prohibiting a taxpayer from delaying completion of a contract for the principal purpose of deferral of tax. (citations omitted) This exception is designed to prevent manipulation of the completion date by a taxpayer putting off a minuscule portion of the work on a contract from one year to the next in order to obtain a year's deferral in income taxation.

Technical Memorandum accompanying Transmittal Memorandum from

the Commissioner to Assistant Secretary of the Treasury, Accounting for Long-Term Contracts and Advance Payments, at 8 (October 11, 1972) Treas. file T.D. 7397, Vol. 6. See also, [REDACTED], G.C.M. 35703, I-2473 (March 4, 1974).

Section 229(a)(1) of the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) directed the Secretary of the Treasury to modify the 1976 regulations relating to long-term contracts "to clarify the time at which a contract is to be considered complete."

The committee believes that the present rules relating to the completed contract method of accounting need to be changed because the income of some taxpayers using that method of accounting is not being clearly reflected. The method has not resulted in a clear reflection of income due, in part, to deferral of the completion of the contract for tax purposes by reason of contractual obligations that are merely incidental to the taxpayer's obligation to build, construct, install, or manufacture the subject matter of the contract. The committee believes, therefore, that the Treasury should amend its regulations to prevent this inappropriate deferral of income. S. Rep. No. 97-494 (Vol I) 97th Cong., 2d Sess. 200 (1982).

The committee bill directs the Treasury to modify its regulations relating to the determination of when a contract is completed and when agreements should be severed or aggregated. Also, the Treasury is directed to modify its regulations relating to the use of the accrual method of accounting with respect to long-term contracts. The committee intends that these modified rules would prevent unreasonable deferral of recognition of income and will apply to all taxpayers who use either the completed contract method of accounting or the accrual method of accounting. S. Rep. No. 97-494 (Vol I), at 201.

The other provisions of the committee bill, which relate to completion of a contract and contract aggregation and severance, apply to taxable years ending after December 31, 1982. In the case of a contract that the taxpayer has not treated as completed before the end

of the taxpayer's first taxable year ending after December 31, 1982, such contract will be treated as completed in such taxable year if, under the regulations to be prescribed as directed by the committee bill, such contract would be considered completed in such taxable year or any earlier taxable year. S. Rep. No. 97-494 (Vol I), at 203. See also H.R. Conf. Rep. No. 97-760, 97th Cong., 2d Sess. 549 (1982).

Accordingly, Treas. Reg. § 1.451-3(b)(2)(i)(A), effective for years ending after December 31, 1982, provides that a long-term contract shall not be considered completed until final completion and acceptance have occurred. Nevertheless, a taxpayer may not delay the completion of a contract for the principal purpose of deferring Federal income tax.

Treas. Reg. § 1.451-3(b)(2)(i)(B) provides that final completion and acceptance of a contract for Federal income tax purposes is determined from an analysis of all the relevant facts and circumstances, including the manner in which the parties to the contract deal with each other and with the subject matter of the contract, the physical condition and state of readiness of the subject matter of the contract, and the nature of any work or costs remaining to be performed or incurred on the contract. In considering the manner in which the parties deal with the subject matter of the contract, any use of the primary subject matter of the contract by the purchaser (except for testing purposes that produces that no gross revenue, cost savings, or other substantial benefits for the purchaser) will be considered.

Treas. Reg. § 1.451-3(b)(2)(i)(C) Example 1 provides that in 1982, A, a calendar year contractor, contracts with B to construct a building. The initial completion date specified in the contract is October 1984. In November 1984, the building is completed in every respect necessary for the use for which the building is intended. Later in November 1984, B occupies the building and notifies A that certain minor deficiencies should be corrected. A agrees to correct the deficiencies. Under these circumstances, the contract is considered completed for Federal income tax purposes in A's taxable year ending December 31, 1984, without regard to when A corrects the deficiencies. The contract is considered completed because the parties have dealt with each other and with the subject matter of the contract in a manner that indicates that final completion and acceptance have occurred.

Treas. Reg. § 1.451-3(b)(2)(i)(C) Example 4 provides that in 1983, D, a calendar year taxpayer, contracts with E to construct a shopping center and related parking areas. The shopping center is completed in October 1985. In December 1985, the

shopping center and three-fourths of the parking area are open to the general public. At that time, the entire parking area of the shopping center has been graded and three-fourths has been paved, but the final asphalt coating has not been laid due to general weather conditions. Under these circumstances, the contract to construct the shopping center and parking area is considered completed for Federal income tax purposes in December 1985, because the shopping center and a major portion of the parking area were ready to be used and were used at that time.

Treas. Reg. § 1.451-3(g)(3) provides that any contract that would be considered to be completed in a taxable year ending before January 1, 1983, solely by reason of the application of paragraph (b)(2)(i)(B) of this section shall be considered to be completed on the first day of the taxpayer's first taxable year ending after December 31, 1982.

In the instant case it is clear that Contract [REDACTED] was not finally completed and accepted within the meaning of the 1976 regulations at any time prior to December 31, 1982, as the [REDACTED] had not met the performance requirements of the contract. Further, [REDACTED] was unwilling to waive the performance requirements which [REDACTED] and [REDACTED] had failed to meet, and continued to demand full compliance with the contract. Cf. [REDACTED] (copy attached). Finally, given the fact that [REDACTED] ultimately spent approximately \$[REDACTED] to bring the [REDACTED] up to the contract standards, it is unlikely that a court would find that completion had been delayed for the "principal purpose of deferring Federal income tax" within the meaning of the 1976 regulations. Thus, taxpayer improperly closed the portion of Contract [REDACTED] relating to [REDACTED] and [REDACTED] during its fiscal year ending [REDACTED].

On the other hand, it is equally clear that the portion of Contract [REDACTED] relating to [REDACTED] and [REDACTED] is properly considered completed under the current regulations when the equipment is first placed in commercial operation. See Examples 1 and 4 cited above. At that point [REDACTED] took over the management of the equipment from [REDACTED], which had been responsible for its initial operation, and began to produce electricity at the designed output for sale to its customers. The remaining costs incurred by [REDACTED] were in the nature of warranty costs, were relatively minor in comparison to the gross contract price, were expended only during periods of routine plant shut-down, were not required for the operation or safety of the equipment, and were intended only to produce a marginal improvement in the fuel efficiency of equipment which was in commercial operation during the period in which the repairs were made. Under these circumstances the portion of Contract [REDACTED] relating to [REDACTED] and [REDACTED] is considered completed for Federal income tax purposes because the [REDACTED] were ready to be used and were used by [REDACTED] in the

production of electricity for sale to its customers.

Under the current regulations, that portion of the contract relating to [REDACTED] is properly closed during taxpayer's fiscal year ended [REDACTED], and that relating to [REDACTED] is properly closed during the fiscal year ended [REDACTED]. The current regulations are effective for taxable years ending after December 31, 1982. Under the transitional rule of Treas. Reg. § 1.451-3(g)(3), a contract which would be considered complete (within the meaning of the current regulations) in a taxable year ending before January 1, 1983, shall be considered complete on the first day of the taxpayer's first taxable year ending after December 31, 1982. Thus, the portion of Contract [REDACTED] relating to [REDACTED] and [REDACTED] is properly considered completed on [REDACTED], and is taxable in taxpayer's fiscal year ended [REDACTED].

Litigation Strategy

Closure of long-term contracts is a coordinated issue in the Construction Industry Specialization Program. There has been no litigation of the closure issue under the TEFRA regulations (but see Guy F. Atkinson v. Commissioner, 82 T.C. 275 (1984), aff'd., 814 F.2d 1388 (9th Cir. 1987), cert. denied, 99 L.Ed. 2d 444 (1988), which involved pre-'82 years). While this case is a transitional rule case, in substance it involves the application of the TEFRA closure rules, and provides the first opportunity for a judicial test of these regulations. Further, a favorable determination by the Tax Court would be of substantial precedential value to the Program.

Given the industry-wide significance of the closure issue, it is recommended that a motion be filed for a separate trial of this issue pursuant to T.C. Rule 141(b). Regardless of how the court rules on the separate trial motion, respondent should seek to have the closure issue resolved on motion for summary judgment pursuant to T.C. Rule 121. This will allow the court to focus on the relevant facts and circumstances: [REDACTED]'s commercial operation of the equipment, the fact that the equipment has continued to function at its design capacity, and the nature and timing of the costs incurred to correct the deficiencies found in the equipment, while limiting the potential for confusion of the issue. While the development of the closure issue is essentially factual, these are not the type of facts over which there should be much dispute, and thus the issue is susceptible to summary judgment.

However, as this issue was largely developed by the taxpayer, and not by Examination, care should be taken to further develop and refine the facts upon which the above analysis is based. Should you have any questions, please contact John MacEachen, Construction Industry Coordinator, at FTS 566-4189.

MARLENE GROSS

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Attachment:

O.M. [REDACTED]